

# Testing strategic trade

**New theories suggest that protectionism can make sense. As the evidence comes in, however, free trade looks better and better**

THE classical case for free trade starts with the idea of perfect competition—where individual producers are so small that they cannot move prices. A newer approach asks what happens when that does not hold, and concludes that free trade may no longer be best.

The debate is more about policy in theory than in practice. Pioneers of the new "strategic trade theory" agree that putting their results to work is dangerous: governments might mismanage the delicate interventions that would be needed, and foreigners could retaliate with intervention of their own (in which case everybody loses). But they have raised doubts about free trade that bolster the case for protection in the minds of many politicians. So it would be good to find that—even in the perfect world where governments are clever, where foreigners turn the other cheek, and where pigs roam the skies—free trade still makes sense.

It does. Mr David Richardson of the University of Wisconsin has just published a new and exhaustive survey\* of the relevant empirical studies. Taken together they say that imperfect competition, far from weakening the case for free trade, strengthens it.

The chart shows the underlying method. Suppose an economy produces just two goods: tweed jackets and VCRs. The more it produces of the one, the less it can produce of the other. The bold curve, which shows how much of the two goods the economy can produce in combination, therefore slopes downwards from left to right. It also bulges outwards, thanks to the law of diminishing returns. The question is, where on this curve should the economy be?

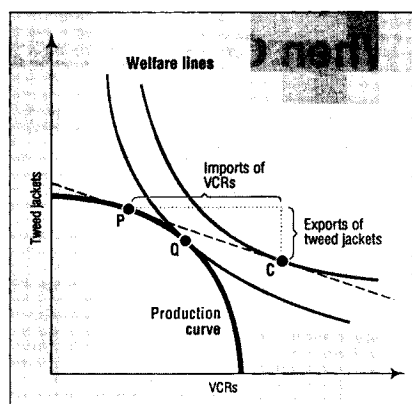
The welfare lines are meant to show society's preferences. Each line joins up combinations of jackets and VCRs that provide the same amount of welfare. The further to the right the line is, the greater the welfare. Again the lines bend; the idea is that if somebody has 50 jackets and one VCR he would need an awful lot of jackets to make up for having one less VCR.

In a closed economy, society achieves its greatest welfare at Q, where the production curve just touches a welfare line. At that point the cost of producing one more VCR, represented by the slope of the bold curve, is the same as the benefit from consuming it, represented by the slope of the welfare line. Under perfect competition these slopes will also be equal to the do-

## ECONOMICS FOCUS

mestic price of VCRs in terms of jackets.

An open economy is different. Instead of facing a domestic-market price for VCRs, it would face a lower world-market price, represented by the slope of the dotted line. Profit-seeking producers would make fewer VCRs and more jackets, shifting the economy's output to P. Welfare-maximising consumers, on the other hand, would want fewer jackets and more VCRs, at C on the higher welfare line. The economy becomes an exporter of jackets and an importer of VCRs. By separating consumption and production, trade lifts the economy to greater welfare.



Protection that fell short of banning trade altogether would mean a steeper price line than the one shown (tariffs on VCRs would raise the domestic price above the world price). Producers would move to between Q and P. The economy could reach a higher welfare line than if it were closed but a lower one than if open.

All of this assumes perfect competition. Under imperfect competition, a desirable shift like the one from Q to C still happens. But new factors also come into play. For example, monopolistic domestic firms make excess profits by charging high prices. Free trade curbs this by promoting competition—hurting producers and helping consumers, for a net gain. Unless, that is, the goods concerned are mainly exported. In that case foreign consumers get the main benefit from freer trade, and the loss to domestic producers may cause an overall loss to the economy. The distorted price, in effect, had allowed access to a higher welfare line.

Imperfect competition makes life complicated. But free trade still looks a good bet—even before taking retaliation and mishandled intervention into account. Remember the initial move from Q to C gives the economy a head start. After that the interaction of free trade and bad prices can go either way, adding to or reducing the gains, perhaps eliminating them altogether. It all depends. Using models (mathematical versions of the chart) that take account of real-world circumstances, it is possible to judge the net effect in particular cases.

Mr Richardson found ten new empirical studies of trade policy under imperfect competition. From all of these it can be deduced that imperfect competition does make a difference, in some cases a big one. So the points raised by strategic-trade theorists cannot be ignored. But free traders need not worry. Four of the studies directly answer the question: what is the effect of freer trade on welfare, comparing perfect competition with imperfect competition? Their answer is that under imperfect competition the gains are bigger.

One study examined the recent free-trade pact between America and Canada. Under perfect competition, the agreement has little effect on welfare. Under imperfect competition, America's gain falls a bit; Canada's rises to 1.2% of GDP. Another Canadian study showed no gain at all from unilateral liberalisation under perfect competition, and a gain of 4% of GDP under imperfect competition. A study of Turkey found that imperfect competition reduced the gains from liberalising car imports, but increased the gains from liberalising imports of tyres and electrical appliances.

One of the most detailed studies reviewed looked at the effects of lower transport costs within Europe after 1992. (This is equivalent to a lowering of trade barriers.) Its results were in line with the others. In ten industries from footwear to machine tools, freer trade produced a net gain in every case. In nine of the ten, imperfect competition made the gains bigger—often by half as much again.

The message is this: the effects of free trade under imperfect competition (smaller price distortions, the forced exit of inefficient firms) yield gains that usually outweigh the losses (the surrender of profits to foreigners). So the new theory of strategic trade turns out to offer no comfort to protectionists after all. The empirical work it has prompted so far says that free trade is not just best, but even better than you always thought.

\* Empirical research on trade liberalisation with imperfect competition: a survey. By J. David Richardson. OECD Economic Studies Number 12.